Box 13

CREDIT RISK PROTECTION BY INSURANCE COMPANIES

Traditional insurance activities are rarely thought of as harbouring significant systemic risk, not least given stringent risk management and the rather illiquid nature of claims inherent in the business models of insurance providers. The financial crisis has illustrated, however, that other non-core activities, which typically bear more similarities to banking activities than to traditional insurance contracts, may embed more potential to disrupt financial stability.

Indeed, the most material insurance event in the current crisis, the near-collapse of American International Group (AIG) in 2008, was triggered by the increased collateral calls on the credit default swap (CDS) contracts that the company had been selling.[1] In particular, activity in writing CDSs has attracted the attention of regulators, academics and the industry itself given their potential for systemic risk.[2] Selling CDS contracts can be placed in a broader context of credit risk activities conducted on the non-life insurance portfolio of an insurer. These activities consist of three distinct types of credit risk protection: credit risk insurance, granting financial guarantees and writing CDSs.[3] This box takes up each of these three activities and their features, and analyses their risk.

A first strand of credit risk activity concerns *credit insurance*, an activity in which many insurers are involved and, as such, is usually classified within core insurance activities. A credit insurance policy insures the policyholder against non-payment of goods and services by their clients. Systemic risk in this field could be related to credit crises that potentially affect many clients simultaneously and can therefore be a source of rapid increases in loss ratios of possibly non-diversified insurance providers. Despite the wide involvement of insurers, the absolute amounts are small, which results in credit insurance accounting for only a very small share of the insurance market.[4]

A second strand of credit risk activity concerns *financial guarantees*, notably those provided by the so-called monoline financial guarantors. A monoline earns its moniker from the fact that it only insures against default of investment-grade debt securities and does not get involved in other insurance businesses. The business model is based on a high credit rating of the monoline, which is justified by them only insuring high-grade securities. The first phase of the US sub-prime financial crisis in the summer of 2007 saw a sharp reduction in these activities.[5]

A third strand of credit risk activity concerns *writing CDS contracts*. In principle, insurers would be natural sellers of such products, because their investment horizon is very long and they are therefore less vulnerable to short-term volatility related to mark-to-market valuations. Insurance companies have typically used CDSs for hedging their credit risk. A low-yield environment can, however, also increase the attractiveness of CDSs as an alternative investment class for insurers.[6] The risk in CDS writing not only arises from the credit risk aspect, but also from the challenges it poses in terms of liquidity: in contrast to traditional credit insurance, CDS writing not only leads to cash flows at the time when an insured credit event occurs, but also to increased collateral requirements in the eventual case that the probability of the event increases. The fact

1 For a comprehensive overview of the AIG near-collapse, see e.g. W. K. Sjostrom, "The AIG Bailout", *Washington and Lee Law Review*, Vol. 66, pp. 493-991, 2009.

2 Systemic risk can arise in particular if these activities are combined with a high level of leverage by the insurance company that is conducting them. For sources, see e.g. Joint Forum, "Review of the differentiated nature and scope of financial regulation – Key issues and recommendations", January 2010; V. V. Acharya, J. Biggs, H. Le, M. Richardson and S. Ryan, "Systemic risk and the regulation of insurance companies", in V. V. Acharya, T. F. Cooley, M. P. Richardson and I. Walter (eds.), *Regulating Wall Street – the Dodd-Frank Act and the new architecture of global finance*, John Wiley & Sons, Inc., New Jersey, pp. 241-301, 2011; Geneva Association, "Systemic risk in insurance – An analysis of insurance and financial stability", special report of The Geneva Association Systemic Risk Working Group, March 2010; CEA, "Insurance: a unique sector – Why insurers differ from banks", June 2010; and most recently, International Association of Insurance Supervisors (IAIS), "Insurance and Financial Stability", November 2011.

3 Overviews of credit risk activities can be found in e.g. Geneva Association, "Systemic risk in insurance – An analysis of insurance and financial stability", March 2010.

4 According to Swiss Re, premiums accounted for USD 6.9 billion in 2005, or less than 1% of non-life premiums written. For a more thorough analysis of credit insurance, see e.g. Swiss Re, "Credit insurance and surety: solidifying commitments", *Sigma*, No 6/2006, 2006.

5 See Box 4 in the June 2008 FSR for an in-depth discussion of financial guarantees.

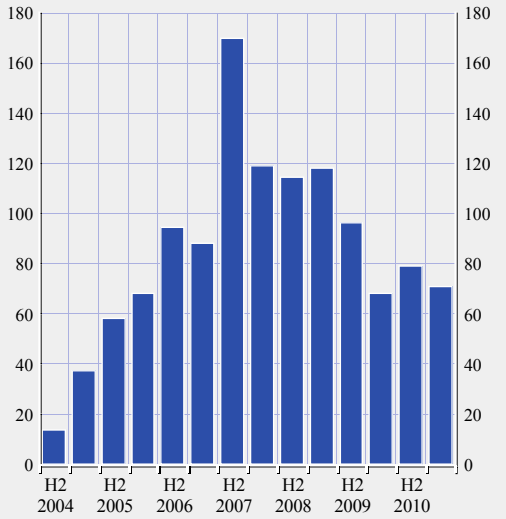
6 See e.g. Fitch Ratings Global Credit Derivatives Surveys of November 2005 and September 2006.

that counterparties to CDS writing are often important banking entities that are closely interlinked with the financial markets may also be a conduit for adverse developments to engender systemic consequences.[7]

Of these three strands of credit risk activity for insurers, CDS activity has the unfortunate coincidence that it both embodies the largest financial stability risks and nonetheless remains the area with what are arguably the most severe data shortcomings – thereby complicating an accurate monitoring of prospective risks. CDS markets remain opaque and comparing data from different sources may yield very different results.[8] Available data suggest indications of a declining trend in the involvement of insurance companies in CDS writing over the past few years. Most importantly, the exit of the biggest insurance player – AIG – from the market in 2008 led to a material decrease of the activity in the insurance sector (see Chart A).[9] At that time, deteriorating credit quality in the financial markets and improving yields in the traditional underwriting business also contributed to other insurance companies having started to reduce their exposures already well before the AIG difficulties.[10] It is noteworthy that CDS writing for purposes other than hedging is forbidden for insurance companies in many countries. As a consequence, insurance companies typically have to found an affiliated, unregulated, entity to conduct any trading using CDSs for income-enhancement purposes.[11] The overall minor significance (2%) of insurers as sellers of CDS contracts, shown in Chart B, reflects these aspects.

Chart A CDS notional amounts sold outstanding – insurance and financial guarantee firms

(H2 2004 – H1 2011; USD billions)



Source: Bank for International Settlements (semi-annual OTC derivatives statistics at end-June 2011).

In contrast, the use of CDSs as hedging instruments has increased during the crisis according to a recent report by the Committee on the Global Financial System (CGFS), and may continue to increase in the coming years.[12] Solvency II will acknowledge the effective use of risk-mitigating techniques in its capital requirements, including via the use of derivatives. For the purpose of risk management, insurers are allowed to use derivatives in their balance sheet, and regulation often requires these exposures to be collateralised and with diversified counterparties. Rather

7 This was the case for AIG, for example. Although collateral calls were the main trigger for the near-collapse of the insurer, it should be noted that increased requests to return the securities borrowed under AIG's securities lending programme also contributed to the unmatched liquidity needs, which were accentuated by the high leverage of the company. See Sjostrom, *op. cit.*, and Box 16 in ECB, *Financial Stability Review*, June 2009.

8 For a thorough comparison of data sources, see ECB, "Credit default swaps and counterparty risk", August 2009.

9 This has led Fitch Ratings to exclude insurance companies from its Global Credit Derivatives Survey. For argumentation, see Fitch Ratings, "Global Credit Derivatives Survey: Surprises, Challenges and the Future", August 2009.

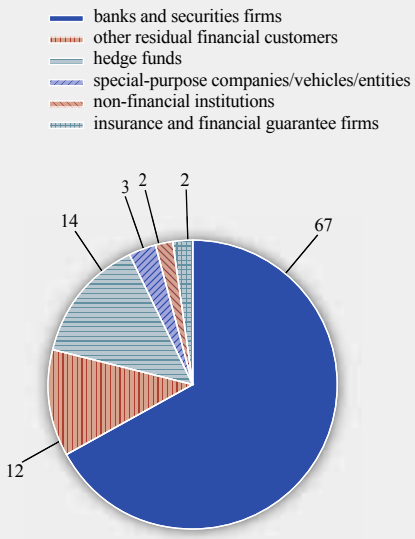
10 This trend is also visible in the Fitch Ratings Global Credit Derivatives Surveys of 2005 and 2006, if AIG's Financial Products Corporation is excluded from the data.

11 AIG, for example, conducted its CDS writing activities via its Financial Products Corporation in London. For a description of the legal framework in Europe in particular, see Box 19 in ECB, "Credit default swaps and counterparty risk", August 2009.

12 See CGFS, "Fixed income strategies of insurance companies and pension funds", July 2011.

Chart B CDS notional amounts sold outstanding – main seller categories

(H2 2011; percentages)



Source: Bank for International Settlements (semi-annual OTC derivatives statistics at end-June 2011).

than CDSs, these derivatives are however typically mostly foreign exchange, interest rate and equity derivatives, to match the financial risks that insurers guarantee. Life insurers in particular use derivatives extensively to reduce interest rate risk.

All in all, available data would suggest that the selling of CDS contracts by insurance companies is not on a scale sufficient to pose a material threat to euro area financial stability at present. Nevertheless, the potential of such activity to be a source of systemic risk should not be underestimated, not least given its role in the aftermath of the failure of Lehman Brothers. Indeed, the loopholes for regulatory arbitrage that have led to a significant systemic event in the past need to be closed. A clear understanding of insurance activities at the consolidated level, as required by the Joint Forum and the CGFS, among others, is key in this regard.